

Leases of real property by an exempt agricultural organization to its taxable subsidiaries for purposes not substantially related to the organization's exempt function are business leases within the meaning of section 514 of the Code.

Advice has been requested whether the leases described below are excepted from the definition of the term 'business lease' in section 514(b) (prior to its amendment by the Tax Reform Act of 1969, Public Law 91-172 (C.B. 1969-3, 10)) of the Internal Revenue Code of 1954 by the provisions of section 514(b)(3)(A)(i) of the Code.

An agricultural organization, exempt from Federal income tax under section 501(c)(5) of the Code (and therefore subject to the unrelated business income tax imposed by section 511), engages in various activities that advance and improve the conditions of farmers in their agricultural pursuits. The organization purchased an office building and leased all of the space for seven-year periods at monthly rentals to its taxable subsidiaries. These subsidiaries sell insurance and farm equipment and provide marketing and other business services for farmers who are members of the organization. The building is subject to a mortgage incurred at the time of its purchase.

Section 514 of the Code defines the term 'business lease' as a lease of real property for a term of more than five years by an organization, if at the close of the lessor's taxable year, there is a business lease indebtedness. A business lease indebtedness is described, in part, with respect to any real property leased for a term of more than five years, as the unpaid amount of the indebtedness incurred by the lessor in acquiring or improving the property. However, section 514(b)(3)(A)(i) of the Code provides that no lease shall be considered a business lease if such lease is entered into primarily for purposes that are substantially related (aside from the need of such organization for income or funds or the use it makes of the rents derived) to the exercise or performance by such organization of its purpose or function constituting the basis for its exemption under section 501.

The leasing of real property to its subsidiaries by an agricultural organization does not in and of itself constitute the exercise or performance of an agricultural function. The organization must establish that the leases are entered into for purposes substantially related to its exempt function in order to demonstrate that the exception of section 514(b)(3)(A)(i) of the Code applies.

Section 1.514(b)-1(c) of the Income Tax Regulations provides that the principles of section 1.513-1 of the regulations are applicable in determining whether there is a substantial relationship to the exempt purpose of an organization. Section 1.513-1(d)(2) of the regulations provides, generally, that a

trade or business is 'substantially related' to exempt purposes only where the business activity has a substantial causal relationship to the achievement of the exempt purpose. Thus, the conduct of the trade or business from which the income is derived must contribute importantly to the accomplishment of the organization's exempt purpose. , \$tAlthough the subsidiary lessees are providing goods and services for farmers, these activities do not advance and improve the conditions of farmers in their agricultural pursuits within the meaning of section 501(c)(5) of the Code. These activities are carried on primarily for the production of income. They have no causal relationship to the achievement of the exempt purposes of the agricultural organization nor do they contribute importantly to the accomplishment of such purposes. See Rev. Rul. 57-466, C.B. 1957-2, 311; Rev. Rul. 60-228, C.B. 1960-1, 200; Rev. Rul. 62-191, C.B. 1962-2, 146, and Rev. Rul. 69-51, C.B. 1969-1, 159.

Based on the facts presented, it is held that the leases described above do not come within the exception provided by section 514(b)(3)(A)(i) of the Code and that they are business leases as defined in section 514.